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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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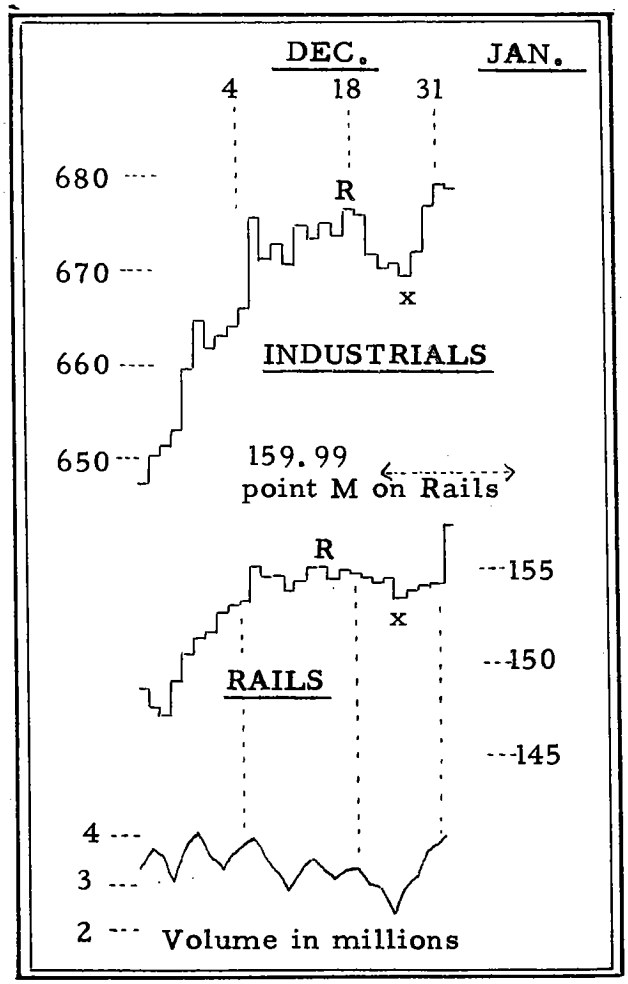
THE MARKET. Rhea pointed out that primary movements tend to be international in scope. If his thesis needed any further proof, it came last year as the stock exchanges of almost every free country in the world (except tight-moneyed Canada) boomed to new highs. It used to be said that the London stock market always topped before and bottomed after ours. This theory was discredited in 1946 when our market topped in May, 1946, and the London market went to a new high in early 1947. During 1959 the London market advanced about 50% while the D-J Industrials moved up a little better than 15%. Whether this reflects a healthier state of affairs in England or whether it suggests that London (and the rest of Europe) is catching up with is is a question for future historians to answer.

The last Letter discussed the narrow "line" structure which had been in effect since December 8. On December 28 both Averages retreated under the line, but the accompanying low volume (2.8 million shares) negated the bearish implications of the move. Both Averages worked back into the line the following day, volume picking up with higher prices. December 30 saw Industrials better the upper line limits on a sharp increase in volume. The climax of the Christmas to New Year's drama came on December 31 as Industrials finally closed above their 678.10 bull market high to the tune of 3.8 million shares.



The New Year (January 4) was greeted by (a) the long awaited announcement of a steel settlement, and (b) a day of divergent movements in the Averages. Although Rails closed 2.19 points above their upper line limit, Industrials ran into heavy afternoon selling which resulted in their recording a fractional loss for the day. Volume expanded to 3.9 million shares on January 4, and by any Dow Theory interpretation, the line has been broken topside by both Averages.

The minor, secondary and primary trends are now all pointing up. It would require a closing below the line's lower limits (Industrials 669.77, Rails 153.32 -- x on chart) on expanding volume in order to reverse the upward trend which is now indicated.

When writing a letter of this sort it is always easier to "follow" the market than to point out future alternatives and possibilities. The former procedure simplifies things tremendously for the writer, but subscribers generally learn little or nothing from it. As readers of these Letters know, I have not, of late, held strong convictions regarding the near-term trend. As this stage of the bull market and as stocks work higher, vulnerability increases, and it becomes a case of safety of principal vs. speculative fever and progressively

riskier profits. Dow's Theory was designed for the investor or trader who has learned to be satisfied with the best and safest part of the swing, and I have frequently stated in these Letters and in advertising that the amateur "in-and-out" trader must lose his money in the long run. Moreover, the bid and asked differential, commissions and taxes are a huge handicap for the "scalper" who, almost by definition, is attempting to beat the professional at his own game. The greedy amateur demands 100% of every swing and a "play" for his money each day. He lacks judgment and patience, whereas I have known veteran Dow Theorists to wait months or even through a whole bear market before making new commitments.

A frequent question now is, "With Industrials through their high, shouldn't I step in here and buy?" I cannot answer the question. In Letter 87 the implications of the Rails' bettering point Ra were analyzed, and I included a letter from one experienced Dow Theorist who had taken on new commitments at that time. There are few times in the life of a "soothsayer" when he can, in good conscience, provide others with absolute "buy" and "sell" advice. Yet each week letters arrive here from new subscribers which describe costly losses sustained through "tips" from well-meaning services and advisers. "He who has absorbed Dow's Theory needs no advice", wrote Rhea. "Moreover, he becomes insulated against the hysteria that causes people to overtrade the final stages of a bull market, while becoming immune against the pessimism which prevents others from buying stocks near the end of bear periods."

I have been writing about the Rail point M (159.99 - see chart) for a good many weeks. The recent bettering of the December "line" should put the carriers in a position to approach or hurdle this important intermediate peak. Should the latter occur, the Rails would appear stronger than at any time since their August, 1959 highs. Rails have a habit of making up for lost time once they start moving, and they can be a profitable speculative medium. For instance, on the move from the 1949 (bull market beginning) lows to the 1956 highs, Industrials advanced 222% while rails advanced 342%. Again on the swing from the 1957 reaction lows to the July-August 1959 highs, Industrials advanced 61% against 81% for Rails. In other words, catching a given swing can often be more profitable with Rails than Industrials. A Rail advance from here to the 1956 Rail bull market high of 181.23 would represent a gain of 21%.

ODD-LOTS. I have frequently discussed the importance of professional as distinguished from public sentiment on the stock market. The odd-lot transactions provide one of the time-tested methods of measuring public sentiment. The odd-lotter (under-100-share-trader) is generally considered to be representative of the public, while the even-lot (100 share) trader is considered to be representative of the professional or investor.

"Prices are controlled by values in the long run," wrote Dow, and this is true, but it is also true that the psychology of buyers and sellers makes the trend. The market consists of two general groups, (a) professionals and astute investors, (b) the public. The public tends to buy at higher levels as the professionals distribute; the public tends to sell at lower levels as the professionals accumulate. For our purposes it is important to realize that, while the instinct of the public is not always wrong regarding price trends, careful studies demonstrate that the public is usually most wrong at or near important turns. Normally, the public tends to optimism (the public normally buys more than it sells), yet the public is usually wrong as to timing and degree.

For instance, during the early part of a reaction the public (the odd-lots) instinctively steps up its buying, believing that lower prices are bargains. If the reaction continues, however, the public will eventually decrease its buying or switch to actual selling on balance. When this change of sentiment occurs, it is usually a sign that the reaction is about over. Conversely, during the early part of an advance the public is normally skeptical of higher prices and will decrease its buying. But if the advance continues the public will eventually step up its purchasing. When this buying becomes excessive

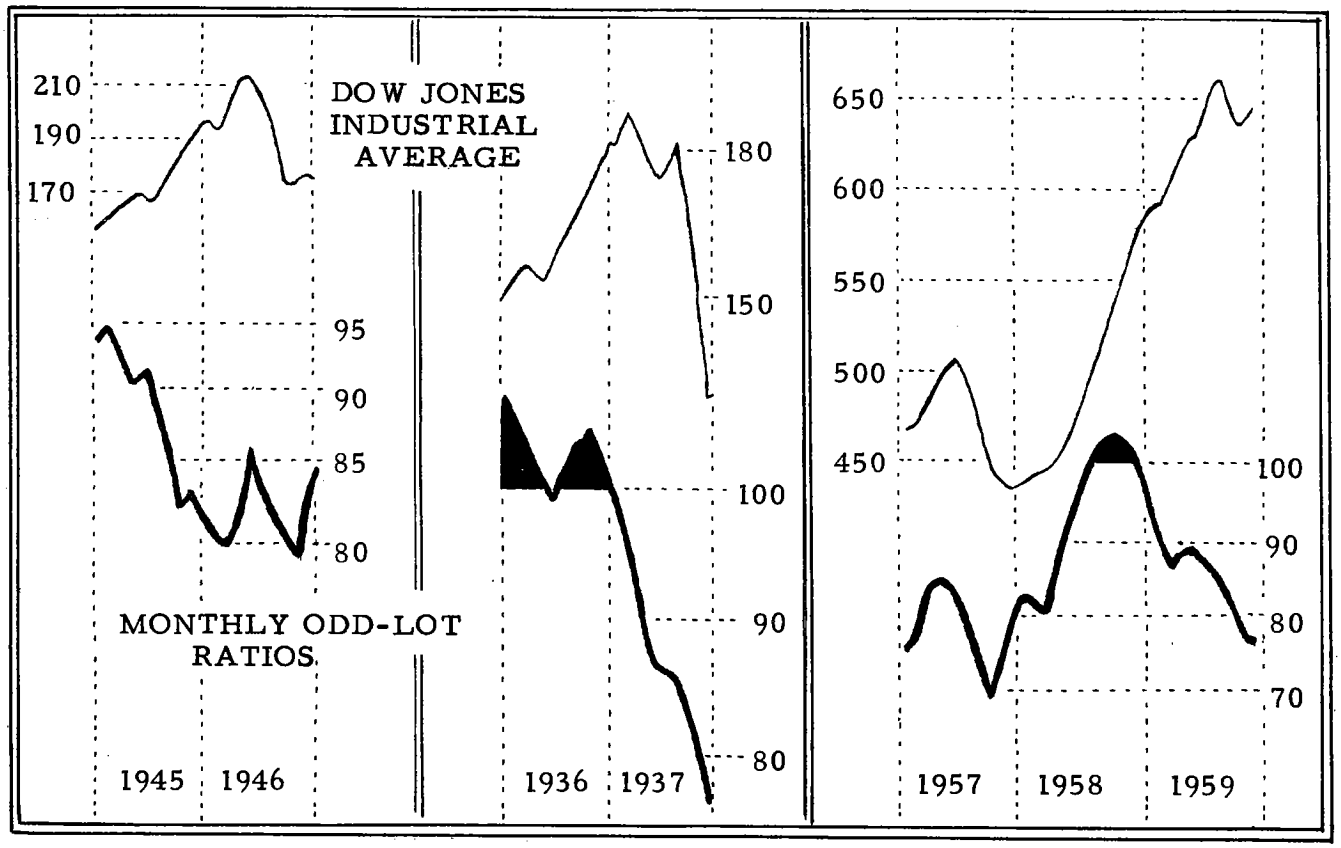
(i.e., when the public is most enthusiastic) the advance is usually at or near an end.

The accompanying charts have been included with the permission of Mr. Garfield Drew; the earlier sections are taken from Mr. Drew's new historical chart book of the odd-lot indexes. The odd-lot ratios shown here are monthly totals of odd-lot transactions (plotted on a three month moving average). This provides a long range picture of odd-lot transactions. The present situation together with the bull market tops of 1937 and 1946 are illustrated with odd-lot ratios plotted under the movements of the D-J Industrial Average.

An odd-lot ratio of 100 indicates that odd-lot buying and selling are exactly even, while anything under 100 shows the odd-lotter moving towards the buying side. At 75, for instance, the Odd-lotter is buying 4 shares for every 3 sold -- a high level of optimism. As mentioned earlier, the public is normally a buyer, and for this reason, we seldom see that ratio move above 100. Anything over 100 (solid black section on chart) indicates that the odd-lotter is selling more than he is buying -- a most unusual phenomonon.

As seen on the chart, the public tended to buy with increasing enthusiasm all through 1945. Optimism waned a bit in early 1946, although odd-lots remained well on the buy side. The bull market topped out in May, 1946, yet the odd-lotters remained enthusiastic and literally bought the whole downward swing from 212 (on the D-J Industrials) to 163! The long trend of increased odd-lot buying through 1945 suggested technical weakness and a top anywhere from late 1945 on.

The odd-lots were actually on the sell side (solid black section) during the big market rise of 1935 and '36, but towards late 1936 they turned increasingly less skeptical. The ratio switched to the buy side in 1937. Although the market topped in March, 1937, the public bought with increasing ferver during the largest part of the collapse which took Industrials from 194 back to 95.



The recession of 1957-58 turned the public coldly bearish, and the chart shows the odd-lotter decreasing purchases through the early part of 1958 (while the stock market was advancing relentlessly). In mid-1958 the odd-lotter (who disbelieved the advance) actually switched to selling more than he was buying (solid black), a sign of tremendous technical strength. Then, with the safest and most profitable part of the swing over, the odd-lotter (early 1959) became more optimistic, and he has remained on the buying side of the market all through 1959. The months of September and October, 1959, saw odd-lot buying at its highest rate of the year, and this coincided with the reaction which took place at that time.

The important thing to realize now is that the odd-lot ratios are no longer the plus factor that they were in 1958. The public has remained on the buying side for almost a year, which means that a good deal of professional distribution has taken place. Although there is no definite point at which the odd-lots will signal the end, we can say that the longer this odd-lot buying continues and the more pronounced it becomes, the greater the forces of technical deterioration in the market, and the greater the likelihood of a top.

PERSONAL OBSERVATIONS. The stock market is taken to discount the effect of coming events, and it has a habit of knocking our preconceived notions into "a cocked hat". Nevertheless, fundamental observations can be of interest. It seems to me that some of the things worth watching in 1960 are: (a) the money picture, (b) farm prices, (c) the import-export balance, (d) management-labor negotiations.

In my opinion, the money picture is the biggest problem facing the country today. We are told that if congress will only raise the 4 1/4% ceiling of Treasury bonds, everything will work out all right. Yet it is certain that Uncle Sam would have to pay over 5% in order to sell a new bond issue, and the way things are going one wonders whether 5 1/4% would stir up much excitement among bond buyers.

When the chips are down, despite all the pious talk, the Government has chosen to take the "easy way". On the January financing the Treasury threw everything into the short-term bill market rather than put out another "magic five". The first issue of magic fives hit the savings institutions like a ton of bricks, since it siphoned off savings which were already committed for other purposes. Bills, on the other hand, have an inflationary effect, because the banks can use them as reserves against which they can borrow.

The steel "settlement" solved no basic issue, it was a costly contract, and it will have the effect of pricing American goods even further out of world markets. Already, many economists are asking whether the Nixon-Mitchell "coup" was not brought off at far too high a price.

(Written January 5th: 2 PM)